

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Florez Analyst: John Pavalasky Bill Number: AB 1250
Related Bills: See Legislative History Telephone: 845-4335 Introduced Date: February 23, 2001
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Marginal Well Crude Oil & Natural Gas Production Credit

SUMMARY

This bill would allow a credit for the production of crude oil and natural gas from marginal wells at a rate of \$3 per barrel for crude oil or 50 cents per 1,000 cubic feet for natural gas.

PURPOSE OF THE BILL

According to the author's office the purpose of this bill is to decrease reliance on oil and gas from sources outside the state and to make the production of heavy oil more economically viable.

EFFECTIVE/OPERATIVE DATE

This bill is not a tax levy and therefore would be effective January 1, 2002, and apply to taxable years beginning on or after January 1, 2002.

POSITION

Pending.

Summary of Suggested Amendments

Substantive amendments are necessary to resolve the implementation and policy considerations discussed in this analysis. Department personnel are available to help resolve these considerations as the bill moves through the legislative process.

ANALYSIS

FEDERAL/STATE LAW

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

G. Alan Hunter for GHG **04/12/01**

Federal law contains a tax credit of \$3 per barrel of oil-equivalent (measured on a British thermal unit (btu) basis) for the production of qualified fuels sold to an unrelated party. The \$3 amount is adjusted for inflation. Qualified fuels include oil produced from shale and tar sand; gas produced from geopressured brine, Devonian shale, coal seam, or tight formations; gas produced from biomass; and liquid, gaseous, or solid synthetic fuels produced from coal.

Federal and state laws allow taxpayers an enhanced oil recovery (EOR) credit based on costs connected to a qualified EOR project that involves the application of a tertiary recovery method, which is expected to result in a significant increase in the amount of crude oil recovered. The federal credit is equal to 15% of the taxpayer's qualified EOR costs. Qualified EOR costs are defined as amounts paid or incurred for qualifying tangible property that is depreciable or amortizable and an integral part of a qualified EOR project, qualifying tertiary injectant costs, and qualifying intangible drilling and development costs. **Federal law** provides various rules regarding eligibility for the EOR credit and interaction with other tax provisions.

The **state EOR credit** conforms to the federal rules with specific modifications. The state EOR credit amount is equal to one-third of the credit allowed under federal law. The state EOR credit specifies that the credit may not be claimed if the taxpayer does not qualify for a specified depletion allowance under federal law. Essentially, retailers, certain related parties, and refineries whose output exceeds 50,000 barrels on any day of the year are excluded. A taxpayer must elect on the original return to have this section or another code section apply if costs of property qualify for any other credit. Any excess credit may be carried over for up to 15 years. The state EOR credit does not reduce the tax below tentative minimum tax for alternative minimum tax (AMT) purposes.

THIS BILL

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would allow a credit for the production of crude oil and natural gas from marginal wells at a rate of \$3 per barrel for crude oil or 50 cents per 1,000 cubic feet for natural gas.

This bill defines the following terms: "qualified crude oil production;" "qualified natural gas production;" "marginal well;" and "reference price."

The phaseout language in the bill provides that the credit would phase out as the "reference price" for the taxable year (i.e. the "reference price" determined by the Secretary of the Treasury for the calendar year prior to the calendar year in which the taxable year begins):

- for all domestic crude oil, rises from \$14 to \$17 per barrel. The "reference price" for calendar year 2000 and therefore used for taxable year 2001 is \$26.73 per barrel.
- for all qualified natural gas, rises from \$1.56 to \$1.89 per 1,000 cubic feet. The "reference price" for calendar year 2000 and therefore used for taxable year 2001 is \$3.60 per 1,000 cubic feet.

This bill specifies that this credit would not apply to any otherwise qualified crude oil or natural gas production if the well from which these products are obtained produces in excess of 1,095 barrels or barrel equivalents.

Credits in excess of the net tax for the taxable year may be carried forward to offset tax in the following years, until exhausted.

IMPLEMENTATION CONSIDERATIONS

Additional definitions for terms used in this bill are needed. "Barrel" and "barrel equivalents" are used in the bill but are not defined, however, several terms used by the bill are defined by reference to federal law definitions. The author may wish to use the federal law definition of "barrel" in Section 29(d)(6) of the Internal Revenue Code and the definition of "barrel-of-oil equivalent" in Section 29(d)(5) of the Internal Revenue Code for the terms "barrel" and "barrel equivalent" used in this bill.

This bill is not a tax levy and thus will not become operative until January 1, 2002. However, the language states that the credit would be allowed for taxable years beginning on or after January 1, 2001. According to the author's office, the bill will be amended to make it a tax levy.

TECHNICAL CONSIDERATIONS

On page 3, line 6, the term "to that amount" is used twice and should be amended to strike out the second use of that term.

LEGISLATIVE HISTORY

SB 38 (Lockyer, Stats. 1996, Ch. 954) enacted the enhanced oil recovery credit. SB 1788 (Karnette, 1997/1998), held in Senate Appropriations, would have excluded from income certain oil or gas production. AB 687 (Calderon, 1999/2000), failed passage in the house of origin, would have allowed additional percentage depletion deductions to independent producers. AB 1610 (Florez, 1999/2000), failed passage in the house of origin, would have allowed a credit equal to an unspecified amount per barrel of crude oil produced from marginal wells located in this state, up to a maximum production of 1,095 barrels of crude oil per well.

PROGRAM BACKGROUND

According to the Division of Oil, Gas and Geothermal Resources in the California Department of Conservation, California is the nation's fourth largest producer of crude oil. It had approximately 45,600 oil and gas wells operating during 1999, the latest year available, and a production of 31.5 million barrels of oil and 281.9 billion cubic feet of associated natural gas during that year.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York do not allow an oil and gas production credit. These states were examined due to similarities between them and California's population and business activity.

FISCAL IMPACT

If this bill is amended to resolve the implementation considerations, implementing this bill would be accomplished during the normal annual update.

ECONOMIC IMPACT

As currently drafted, the revenue impact of this measure will be nil. The proposal will authorize a tax credit of \$3 per barrel for the heavy oil produced from marginal wells, as well as a credit of \$.50 per 1,000 cubic feet for natural gas produced from marginal wells.

In both cases the amount of credit so calculated will be reduced as follows. In the case of oil production, the credit will be reduced by an amount that bears the same ratio to the calculated credit as the excess, if any, of the applicable reference price above \$14 bears to \$3. (If the reference price for crude oil production equals or exceeds \$17, the credit for crude oil under this bill is completely eliminated.) In the case of natural gas, the said ratio will be calculated as the excess, if any, of the natural-gas reference price above \$1.50 divided by \$.33. (If the reference price for natural gas production equals or exceeds \$1.89, the credit for natural gas under this bill is completely eliminated.)

The year 2000 reference price for oil is \$26.73 per barrel, and that for natural gas is \$3.60 per 1,000 cubic feet. These reference prices result in adjustment "ratios" of 4.24 for oil and 6.36 for natural gas, completely wiping out the tax credit proposed under this bill.

ARGUMENTS/POLICY CONCERNS

The production credit at the federal level (Section 29, Credit for Producing Fuel from a Nonconventional Source), which the credit proposed by this bill most closely resembles, requires that the oil or gas produced by the taxpayer be sold by the taxpayer to an unrelated person during the taxable year. However, this bill would allow the credit for oil or gas produced but that remains unsold (i.e. stored) at the end of the taxable year.

This bill specifies that this credit would not apply to any otherwise qualified crude oil or natural gas production if the well from which these products are obtained produces in excess of 1,095 barrels or barrel equivalents during the taxable year. Rules are not provided to pro-rate this limitation in the case of short taxable years or years with limited production. The author may wish to include specific rules to resolve this issue.

The phaseout language in the bill provides that the credit would phase out as the "reference price" for the taxable year (i.e. the "reference price" determined by the Secretary of the Treasury for the calendar year prior to the calendar year in which the taxable year begins):

- for all domestic crude oil, rises from \$14 to \$17 per barrel. The "reference price" for calendar year 2000 and therefore used for taxable year 2001 is \$26.73 per barrel.
- for all qualified natural gas, rises from \$1.56 to \$1.89 per 1,000 cubic feet. The "reference price" for calendar year 2000 and therefore used for taxable year 2001 is \$3.60 per 1,000 cubic feet.

Since the "reference price" has reached levels significantly higher than the maximum phase out range for this credit, it appears that no credit would be allowed. The author may wish to revise the bill to provide a different phase out range.

The bill uses the term domestic crude oil and domestic well, however, under federal law definitions, that term refers to production from an oil or gas well located in the United States or in a possession of the United States. If the author wishes to restrict the eligibility for the credit to oil or gas produced from marginal wells located in California, the bill needs to be amended to add "located in California" to the term "well" in each place in that it appears.

This bill does not reduce the credit allowed by this bill by any California EOR credit to which the taxpayer is entitled. Thus, the taxpayer may be eligible for two credits for the same oil production. The author may wish to provide that the credit provided by this bill is to be reduced by the amount of any enhanced oil recovery credit allowed under Section 17052.8 or 23604 with respect to a qualified enhanced oil recovery project on a well that produces oil or gas eligible for the credit provided by this bill.

This bill does not specify a repeal date or limit the number of years for the carryover period. Credits typically are enacted with a repeal date to allow the Legislature to review their effectiveness. However, even if a repeal date were added, the department would be required to retain the carryover on the tax forms indefinitely because an unlimited credit carryover period is allowed. Recent credits have been enacted with a carryover period limitation since experience shows credits are typically used within eight years of being earned.

LEGISLATIVE STAFF CONTACT

John Pavalasky
Franchise Tax Board
845-4335

Brian Putler
Franchise Tax Board
845-6333